The Manufacturers Hanover
Economic Report

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Triangulation

Long a preoccupation of the financial markets, Federal Reserve watching recently reached new heights (or maybe I should say, new lows). As if speculation over the weekly money supply figures was not enough, the markets since late October have become transfixed over the discount rate—on a daily basis. No doubt concerned over the surge in money growth since midyear, investors evidently were seeking reassurance in the form of further cuts in the discount rate that the Fed would continue "to attach much less than usual weight to movements in M1", as Federal Reserve Chairman Paul A. Volcker told the Business Council meeting last month in Hot Springs, Virginia.

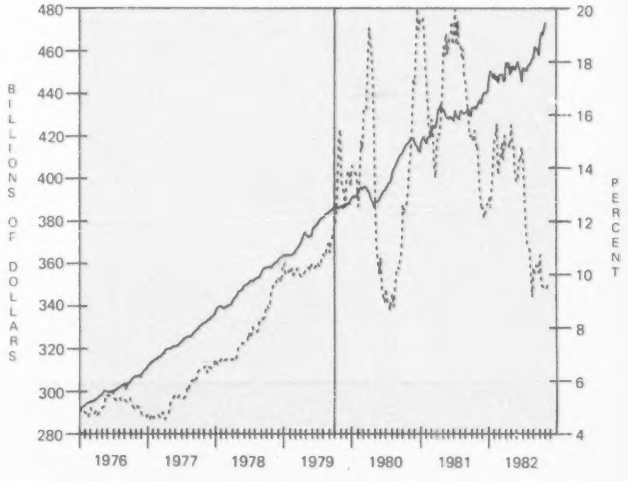
I can understand this, since to go back to strict monetarism at this time would mean that the Federal Reserve would have to drain a sizable amount of reserves from the banking system thereby pushing interest rates skyward. Since it was high interest rates that depressed the economy earlier this year, sending business failures and unemployment soaring to postwar highs and causing strains to develop in the financial system, the markets were sensitive to the possibility that rates might rise again while the economy remains weak.

In the final analysis, though, investors' main concern is for the state of the economy—as is that of the Federal Reserve, the Administration, businessmen and just about everyone else. As a result, they may have to accept the fact that changing economic and financial conditions may change the methods and objectives of Fed policy. In other words—because of the dramatic slowing of inflation, the changed monetary environment due to new regulations and increased sophistication, as well as the weakened state of the U.S. economy and our trading partners as well, it may not be as easy to track the Federal Reserve in the future as it was in the past. This is because the Federal Reserve may soon look at more than just money or interest rates, before making its decisions.

Monetarism Produced Side Effects . . .

A look at recent history provides some insight into why the Fed may find it useful to broaden its policy objectives. In late 1979 and early 1980, inflation was clearly the number one problem here in the U.S. and worldwide. The Fed became convinced that inflation in the longer run sense is a monetary phenomenon that can exist only when there is an excess amount of money in the economy relative to the amount of goods and services the system can generate. Accordingly, in October, 1979, the Fed changed tactics and began trying to control the money supply.

CHART I
MONEY SUPPLY – M1 (LINE) VS. FEDERAL FUNDS RATE (DOT) <WEEKLY FIGURES>



I am not so sure that precise control over the money supply was sought after by the Fed as much as providing the markets with a means of evaluating its policies. You see, the Fed had to establish credibility that it was going to bring down the rate of inflation because if it did not, inflation probably would have spiraled upward even faster. Since the money supply number was available weekly, it provided a convenient and timely guide, when plotted against the Federal Reserve's announced annual target ranges, to judge whether the Fed was doing what it said it would do.

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The policymaking process at last achieved sufficient discipline to convince people that the Fed would stay the course. Inflation moderated into single digits by mid-1981 and has continued to improve since. Consumer prices in 1982 very likely rose by only about five percent—the best annual performance since 1976.

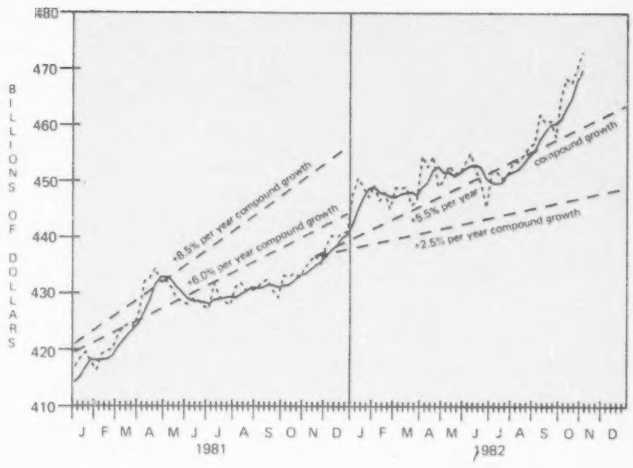
Even as it was succeeding in bringing down the rate of inflation, the Fed soon saw that its conversion to monetarism was producing some disturbing side effects. As was expected, interest rates became much more volatile day-to-day after October 6, 1979 than before. While this volatility dampened somewhat as the months went by, the gyrations were still large enough to cause money market participants to add a premium to the level of interest rates in order to compensate for this volatility. To make matters worse, the money supply seemed to fluctuate more after the Fed's policy switch than it did before (Chart I)! The net result was that interest rates did not come down as rapidly as inflation did, and real interest rates soared to the highest levels in half a century. In an effort to moderate these trends, the Fed tried on several occasions to shift the focus away from the weekly money supply figures. It was unsuccessful in each attempt, and interest rates held high, not dropping significantly until midyear 1982.

The sharp drop in interest rates which got underway in early July led to speculation that the Fed was easing. In actuality, the Fed had not changed its policy objectives at all, but rather, was following its previously articulated policy of trying to keep the money supply in the target range. It was the money supply dropping into the target range that led the markets, themselves, to relax and interest rates to begin falling. As the money supply continued to plunge the Fed began to inject reserves into the banking system in order to bring interest rates down to a level that would be consistent with some growth in the money supply once again. These developments took place amidst a backdrop of well-publicized strains in the financial system coming from a variety of sources.

. . . That Led To Hopes For A Change

It was these problems, along with the still-dismal prospects for the U.S. economy and those of its trading partners that caused participants in the financial markets to begin hoping that the Federal Reserve was going to shift gears. While remaining concerned about the money supply and inflation, the markets were beginning to worry more about interest rates and recession. Accordingly, they did not react adversely when continued injections of reserves into the banking system caused the money supply once again to go up over the target range. Indeed, as the view spread that the Fed had eased, it resulted in the most powerful stock market rally in history.

CHART II
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE)
VS. WEEKLY FIGURES (DOT)



The jump in stock prices, as I indicated last month, did not occur because of any fundamental change in business conditions nor, obviously, because the Federal Reserve was keeping the growth of the money supply down. Rather, it occurred because of a belief on the part of investors that the Fed was once again looking at interest rates and as a result, was going to keep them down—if not push them lower. To be sure, this was not a widely held view outside of Wall Street. Fed officials took special pains to state that they had not changed the basic objectives of monetary policy, which were to control money growth and fight inflation. Various Fed watchers pointed out that over more than just a short period of time, the Fed cannot push rates lower even if it wanted to. They indicated a belief that the Fed was still fighting inflation and that this was the only "responsible" course for a central bank to take. Others, however, swore up and down that the Fed had eased monetary policy while still others came to the conclusion that the Fed was beginning to look at other objectives. To borrow some words from a famous user, monetary policy once again seemed to be "a riddle wrapped up in a mystery inside an enigma."

In recent months it has become clear that the economy's failure to grow over the past three years traces to the conflict that developed between monetary policy and fiscal policy when the Fed switched to monetarism. Fiscal policy, measured by Washington's budget deficits and associated borrowing requirements, was stimulative, while monetary policy was restrictive. Tight money succeeded in slowing inflation—but all that the loose fiscal policy did was to accentuate the effects of tight money by reducing even more the availability of funds for the private sector in order that Washington could satisfy its financial appetite.

If The Fed Monitors Several Indicators . . .

Bringing down the budget deficit will be extremely difficult as long as defense spending and the tax cut program are deemed sacrosanct. But if economic growth were to resume, the increased tax revenues might start the process going and make it easier for the Administration and Congress to compromise on other measures needed to slice the deficit. I think such growth might occur if the Federal Reserve were to broaden its monetary policy objectives. It seems to me that the Fed might be better able to establish conditions conducive to economic growth by looking at more than one indicator in the implementation of monetary policy. I suggest that it look at three: the money supply, prices and interest rates. In other words—the Fed should triangulate as it sets monetary policy.

Triangulation is nothing new. It is, of course, widely used in navigation, where several readings are taken at different points to determine the course that the vessel is on and whether it is the right one. Gunners in the artillery use this strategy to zero in on their target. Triangulation is also common in sporting events: Football games have several referees in order that the action can be better observed, as do other sports. And as any golfer will tell you, it is always easier to find the ball when there is a caddy down the fairway watching it from another perspective besides the view that the golfer gets from the tee.

As far as monetary policy is concerned, triangulation would seem to make a lot of sense. First of all, Paul Volcker, himself, has repeatedly expressed caution about the use of any single measure of money and credit, saying, "we have to be alert to the possibility that relationships may be disturbed by technological or regulatory changes in banking, or more broadly by shifts in liquidity preferences and velocity." He added last month: "in the circumstances, I do not believe that, in actual implementation of monetary policy, we have any alternative but to attach much less than usual weight to movements in M1 over the period immediately ahead."

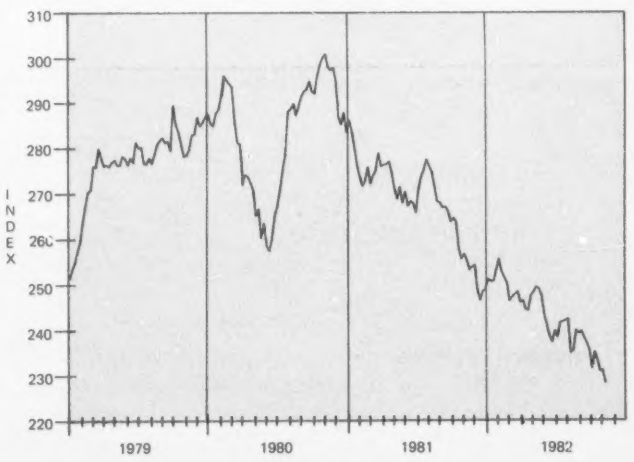
Chairman Volcker is very much concerned about restoring price stability. He believes that continued progress toward this objective is an essential part of building a solid base, "not just for recovery, but for sustaining expansion over a long period. Concern about inflation . . . is not something we can turn on and off; it will be a continuing priority concern of policy."

As for interest rates, Chairman Volcker's view is that lower interest rates are consistent with the needs for recovery. He feels, however, that the Fed cannot artificially force interest rates down. Rather, what is needed is market conviction that the fundamentals are consistent with lower interest rates: "over longer periods of time, achieving and maintaining the lower level of interest rates we would all like to see must, in a sense, be a reward for success in dealing with inflation . . ."

The above quotes are taken from Paul Volcker's speech to the Business Council last month. They suggest to me that the Federal Reserve may now be receptive to triangulating monetary policy. Such a policy would seem to be appropriate in today's environment. First of all, inflation may not be licked entirely but it is not the problem that it was three years ago. Accordingly, the Federal Reserve does not have to lock itself into the automatic pilot of M1 manipulation in order to establish its credibility as an inflation fighter.

Monetarism was the right policy three years ago, and even through most of 1981. However, it has become less and less useful—especially since the Fed undershot its 1981 growth targets and did not make allowances for this in establishing the position for the 1982 targets (Chart II). By midyear 1982, the Fed had worked itself into a corner that would not allow it to let interest rates fall. Since the money supply was growing above target throughout the first half of 1982, the markets began to conclude that interest rates were bound to stay high. If the Fed were to try to push rates down, the surge in money growth would result in higher interest rates. On the other hand, if the Fed were to turn back to looking at the money supply to the exclusion of everything else, interest rates would also rise. Either way, Fed actions (or inaction) could have worsened an already poor business climate. Thus the Fed seized upon the opportunity presented by the maturing all-saver accounts to downplay the M1 figure in early October.

CHART III
TUESDAY SPOT PRICE INDEX – ALL COMMODITIES
(1967=100)



The Fed can continue to throw up enough of a cloud of dust over the M1 figures to keep it from having to tighten until at least spring 1983. This is because the

upward distorting effects on M1 from the maturing all-savers accounts will soon be followed by downward distorting effects as the banks begin offering money market fund-type accounts which will be classified in M2. Then comes the new year and a new set of monetary growth targets.

If the past is any guide, the Fed will use as the base for its 1983 targets the average level of money for fourth-quarter 1982. This would position the new targets above the target bands for 1982—exactly the reverse of what happened between 1981 and 1982. Then, as you can see from Chart II, the Fed undershot its targets thereby positioning the 1982 targets well below the 1981 band, causing monetary policy to be unduly restrictive. But even 1983's higher bands might not be enough to match demand pressures for money, given the Federal government's prospective budget deficit. Hence, a return to money supply targeting alone will eventually lead to higher interest rates, which are bound to stifle the economy.

. . . It Will Help Growth Resume

In the interests of promoting real growth, the Fed ought to add two indicators to its policy objectives, besides money growth. For there are times when the needs of the economy dictate more money even though the money supply may already seem to be growing too rapidly. For example, the swift deceleration of consumer price inflation in the U.S., along with the actual plunge in commodities' prices worldwide, suggests that the Fed may have been a bit too zealous in slowing monetary growth. Of course, whether it would have been able to slow inflation at all had it taken a more gradual approach remains open to conjecture. The point is that commodities prices are still falling (Chart III) and this may be indicative of the need for more money to be pumped into the system by our central bank—and by other central banks as well.

Some would have the Fed look at the value of the dollar in conducting monetary policy. I do not think the relative strength or weakness of the dollar in of itself is something that the Fed should be all that concerned about. It could very well be that the dollar might be strong relative to other currencies even under a period of rapid inflation in the U.S. because inflation elsewhere is worse. If the Fed were to take this to mean that it should conduct an easier monetary policy, it would only worsen our inflation and probably cause inflation elsewhere to worsen as well.

I think the third leg of the triangle that the Fed should use in charting the course of real growth for the U.S. economy is interest rates. To be sure, I am not suggesting that the Federal Reserve try to stabilize either nominal interest rates or real interest rates (interest rates minus inflation). Attempting to do both in an era of large budget deficits can only result in rapid money growth and a return to high rates of inflation. All I am saying is that the Fed should look at interest rates (particularly real interest rates) as part of a three-pronged effort to generate economic growth.

For example, as noted above, the rate of consumer price inflation has slowed while commodities' prices are actually declining. At the same time, the U.S. and many of its trading partners remain mired in recession. A glance at real interest rates shows that they are well above their historical norms (Economic Report—Oct., 1982). This suggests that they may be too high to allow growth to resume. A triangulating monetary policy would therefore call for more reserves to be injected into the financial system with the intent of lowering real interest rates enough so that growth can resume. As long as real interest rates remain positive (and slightly above historical norms), inflation should not flare up. If it does, the Fed, by watching the price indices, will know soon enough to take appropriate steps.

Conclusion

This exposition is not designed to provide the ultimate answer to our economic problems. For even a three-cornered monetary policy is not sufficient to counter the effects of a fiscal policy that is locked in the "full steam ahead" position. However, as I observed above, this might offer an opportunity to start the budget deficit on its long-needed downhill course by providing enough liquidity for the economy to grow, hence, generating additional tax revenues.

The alternatives to triangulation do not seem very bright. If the Federal Reserve goes back to watching the money supply only and the government continues to run large and growing budget deficits, then we will be in for more of the same in 1983 and 1984 that we experienced from 1979 through 1982. On the other hand, if the Fed is forced by Congressional fiat to target either interest rates alone or prices alone, as several bills now pending call for, the end result could be a new round of inflation even worse than that experienced in the late 1970s and early in 1980.

To paraphrase Winston Churchill, one could say that triangulation may be the worst policy devised by the wit of man—except for all the others. ■

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Questions

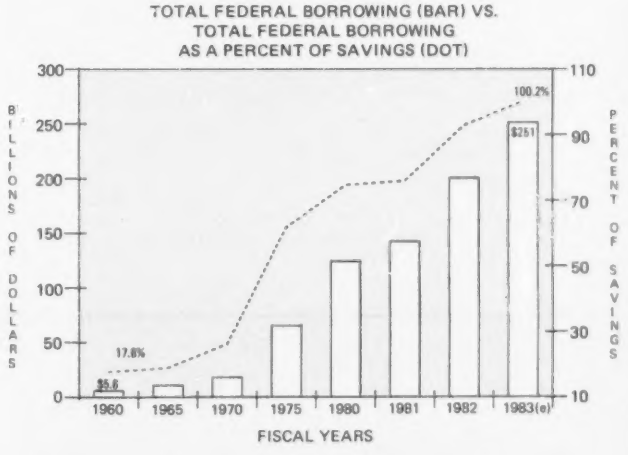
Nineteen hundred eighty-two will go down in the economic annals as the year of surprises. Not only did the U.S. economy fail to pick up the way most forecasters thought (and policymakers hoped), but it stayed down in the face of developments that in the past would have sent business soaring. Additionally, certain things happened that produced exactly the opposite effects compared with many economists' expectations. What follows is a list of questions chosen to illustrate the unusual developments that occurred in 1982 and my answers, which I hope will shed some light on 1982's performance and, in the process, indicate what ought to be done to improve business in 1983.

Why did the huge budget deficit posted in fiscal year 1982 fail to stimulate the U.S. economy?

This is a very reasonable question, since traditional Keynesian analysis suggests that when the Federal government runs a deficit in its budget, it is adding to aggregate demand in the economy. A big enough deficit, this reasoning goes, should be enough to offset whatever shortfall occurs in demand from the private sector. And indeed, this is exactly what happened once it was employed in the 1930s, although it took the huge spending associated with World War II to get us out of the Depression. But a budget deficit must be financed. And if the government's borrowing results in either less funds or costlier money available to the private sector, then its deficit will not only fail to stimulate the economy, it will make it weaker. The economy weakened in 1982 because, unlike the years 1933-40, when the money supply was growing at a 10 percent annual rate, the money supply barely grew at all between January and July 1982, and was only about four percent higher than the level reached 15 months earlier. As a result, the government's total borrowing needs in 1982 equalled over 90 percent of net national savings, compared with 75 percent in 1980 and 26 percent in 1970 (chart).

But interest rates were lower in 1982 than in 1981. Why did they fall in the face of rising budget deficits?

The decline in interest rates from their 1981 peaks should be viewed as a result of several sequential developments. The first dealt with the fact that the money supply during the last seven months of 1981 grew below the Federal Reserve's target ranges thereby easing market fears regarding future trends in Fed policy and inflation. Their declines in 1982 initially reflected the impact of a continued weakening of business activity, thus a slowing of the private sector's needs for funds. Later on, in the summer, rates were pushed down further by an easing of monetary policy. In other words —declines in interest rates over the past year and a half occurred because Washington's budget deficits crowded out the private sector, dampening economic activity, and not the reverse. They also reflected either changes in market psychology, in demands for money by the private sector or in the Fed's willingness to increase the supply of money.



A slow rate of money growth seems to result in lower interest rates while a faster rate of money growth seems to cause interest rates to go higher. Doesn't this violate the basic law of supply and demand?

It certainly does, but it is a by-product of the Federal Reserve's conversion to monetarism in October, 1979. Because the Fed announces its growth target objectives for the money supply each year, and because the money supply figures are available weekly, the markets

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are able to keep very close watch over the Fed's money market activities. And as a consequence of the widely held belief that too much money causes inflation, the markets will bid up interest rates when they see the money supply growing rapidly because they fear that it will result in either higher rates of inflation, which leads to higher interest rates longer term, or a tightening up on the part of the Fed, which also causes higher interest rates—in this instance, relatively sooner. Conversely, when the money supply grows more slowly, the markets will mark down interest rates, anticipating either less inflation or a loosening of Fed policy—both of which would tend to produce lower interest rates.

Well if that's the case, then how come the Federal Reserve has been able to increase the money supply at a 20 percent annual rate since mid-summer, pushing it far above its annual target bands for 1982, and yet interest rates fell?

Because the Federal Reserve has managed to convince the markets to overlook this, claiming that the validity of the money supply figures has been distorted by "technological or regulatory changes in banking, or more broadly by shifts in liquidity preferences and velocity." What this means is that the unusual severity of the recession may have changed people's attitudes toward holding money balances and that the Fed believes that it would not be inflationary to produce money at a faster rate of speed since people are not spending it as fast as they used to. In addition, there is a possibility that the maturing All-Savers Certificates, along with the new money market interest rate accounts that banks can now offer, are further distorting the money figures. Finally, as I observed two months ago, the money supply has not expanded all that rapidly, when viewed over a two-year period.

Then why have lower interest rates not revived economic activity?

First of all, interest rates have fallen at a slower pace this time, compared with previous cycles. Secondly, interest rates may be down in nominal or quoted terms, but they are still historically high when compared with inflation. Indeed, during the 1973-75 recession as well as the brief downturn of 1980, real interest rates were negative—that is, they were below the 12 month rate of inflation prevailing at those times. Those levels of interest rates provided great incentives for people to borrow in order to buy new cars, houses and other major items. It was also an inducement for business to borrow in order to build inventories and increase its capacity to produce. Conversely, high real interest rates are a deterrent to spending because the ability to obtain a rate of return above the inflation rate is a powerful incentive to save. High real interest rates are a deterrent to borrowing, since, in the case of business, these costs can neither be absorbed nor passed along. By the way, high real interest rates depressed the economy in 1982 in another way—by causing the dollar to be overvalued compared with foreign currencies thereby depressing exports and promoting imports.

FEDERAL BUDGET DEFICIT PROJECTIONS

($ billions; fiscal years)

	Date of Projections			
	Jul 81	Sep 81	Feb 82	Apr 82
Office of Management and Budget				
1982	– 42.5	– 43.1	– 98.6	–100.5
1983	– 22.9	– 22.9	– 91.5	–101.9
1984	+ 0.5	0.0	– 82.9	– 93.8
Congressional Budget Office				
1982	– 29.6	– 65.0	–109.0	–119.3
1983	+ 17.7	– 55.0	–157.0	–182.0
1984	+ 76.3	– 50.0	–188.0	–216.0

Why did interest rates not fall as quickly as the rate of inflation?

No one knows with any certainty, but it seems to me to trace to several recent developments. The greater volatility of both interest rates and the money supply following the Federal Reserve's shift to monetarism three years ago seems to have added a "volatility premium" to the level of interest rates besides the inflation and rent premiums, both of which had been embodied in interest rates for many years. In the summer of 1981, another premium might have been added, one that, for lack of a better term, could be called a "fear" premium. The markets got scared beginning in the summer of 1981 when Washington revealed that the government's budget deficits were not going to get smaller and eventually disappear by mid-decade, but rather, were going to get bigger and expand into the 12-digit territory (table). The fear was that either these deficits and their associated borrowing requirements would overwhelm the money and credit markets, driving up interest rates in the process—or that they would not; that the Federal Reserve would monetize these deficits, but in the process, set the stage for a new round of inflation.

Why was the money supply more volatile after October 1979 (when the Fed tried to control it) than before (when the Fed didn't)?

There are several reasons for this. The first deals with activities at the Federal Reserve's discount window. There have been times when the difference between the Federal funds rate (the rate banks charge each

other for overnight loans) and the Fed's discount rate (the rate that the Fed charges the banks when they borrow from it) has been quite large. The bigger this spread, the more some banks may have sought to meet their reserve requirements by borrowing from the Fed at lower costs than from another commercial bank. This spread tends to widen during periods when the Fed is trying to tighten monetary policy. Ironically, the tighter the Federal Reserve thinks monetary policy is getting as it pushes up money market interest rates, the easier policy may actually be, since the greater are member bank borrowings. Thus, notwithstanding whatever reductions in nonborrowed reserves the Fed may have aimed for in its open market operations, control over total reserves was less effective than it could have been because of the existence of this below-market discount rate, which the Fed calls an "escape valve." At any rate, the linkage between nonborrowed reserves and the money supply is not all that tight.

Another factor contributing to the volatility of money may have been the increased volatility of interest rates that developed in the wake of the Fed's switch to monetarism. It had been anticipated, of course, that interest rates would be more unstable once the Federal Reserve stopped paying much attention to controlling them, but the degree of volatility was far beyond market expectations. As interest rates swung, so did the demand for different types of money balances, with the result being unpredictable changes in liquidity preferences on the part of holders of money. Financial innovation has further blurred the distinction between the monetary aggregates, while the frequent and growing forays into the markets by Washington to satisfy its financing requirements undoubtedly had contributed to monetary instability as well. For this has added yet another unpredictable element to the demand for money, thus creating greater difficulty in forecasting when a given level of reserves in the banking system will be translated into money. By the way, if you think that money and interest rates are volatile now, wait until the banking system switches to contemporaneous reserve accounting. Under CRA, both the banks and the Fed will have even less time to adjust to changes in the banking system's needs for reserves than they do now. (For a fuller explanation of this, see the February, 1982 Economic Report.)

What will it take to get real interest rates to decline to more normal levels?

Since the rent component of money costs is unlikely to change any time soon, there must be sizable reductions made in the fear and volatility components. This means that Washington has to produce signs of progress in reducing the budget deficit. In addition, the Federal Reserve has to adopt a monetary policy that reduces the volatility in both interest rates and the money supply—something it may have already moved toward.

Why did our trading partners complain that high U.S. interest rates caused the dollar to become overvalued—yet when our interest rates fell they cut their interest rates thus maintaining the unusual spread between our money costs and theirs which contributed to the dollar's rise in the first place?

In 1981 and early 1982 inflation was still a front-burner issue for many of our trading partners. As their currencies sank relative to the dollar, their domestic inflation rates were boosted because of the higher prices that they had to pay for imported merchandise—much of which is denominated in dollars. By summer 1982, the pervasiveness of recession overtook inflation pressures, causing inflation to slow and many commodities' prices to actually decline—not the least of which was oil. An undervalued currency helps cushion the impact of recession by keeping exports strong and imports weak, yet does not do much damage to domestic prices in a period of reduced inflation. Thus when our interest rates fell, other countries quickly lowered theirs in order to help revive their domestic economies.

Why don't the rules of economics work the way they used to?

They work—we just don't follow them. For example, Keynesian economics suggests that Washington run budget deficits only in bad times and run surpluses in good times. That this rule has been violated can been seen in the historical record, whereby we have run only two annual budget surpluses in the past 25 years! Another rule is that big budget deficits and tight money do not mix. Yet, this has been the hallmark of this Administration's economic policy from the day it took office—not to mention during the 1980 Presidential campaign. As for monetarism, it has proven to be an effective medicine for bringing down inflation but does not have by itself the capacity to revive economic growth. And "supply side" economics, as the term is used today, will stimulate business investment only after two other criteria are met: Capacity utilization must be higher and real interest rates must be lower. In the absence of these two key criteria, the kind of incentives embodied in today's version of supply side economics will not be sufficient to prod businessmen into investing in new machinery and equipment so badly needed to boost productivity and to improve their competitiveness with companies based abroad.

As you can see, even the stickiest of questions can be answered. But whether these lessons will be learned by economic policymakers remains to be seen. If they don't, they will have an opportunity to learn them again, for as the philosopher George Santayana once said, "those who cannot remember the past are condemned to repeat it." M

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The Truth About Country Debt

"Neither a borrower nor a lender be."
—Polonius in Shakespeare's *Hamlet*

In the past few months a lot of paper, ink, and air time has been devoted to the subject of country debt. Authors, not all of whom are expert at all in international finance, are telling us that "hundreds of billions of dollars in outstanding loans to developing countries are at risk today," and that this "crushing debt burden threatens the international banking system with collapse." Many publications take every opportunity to assert that bankers have been "imprudent, reckless, or worse" in making these "illiquid" loans, and that they should be written off in whole or part in order that the banks "cleanse" themselves—in the process slashing their earnings, dividends, and most likely payrolls as well. One business journal claims that in international lending the banks have pursued a "greater fool theory" where there would always be someone to "bail them out" in the event of trouble.

Debt Needed For Growth

As a prominent politician of many decades ago was fond of saying: "Let's look at the record." I don't think anyone would question the notion that debt is an important means of generating growth and improved living standards. On an individual basis, without credit it would be impossible for most people to buy all but the barest of necessities. A car and a house would be out of question—not to mention things like a college education for the youngsters. At the corporate level, credit is used to pay for the cost of starting up a business, producing the goods and services, and distributing them—all of which must be paid for in advance before sales revenues come in. The need for expansion and modernization requires debt as well.

At the country level, credit is necessary for trade financing, the development of industry and infrastructure, and so on. And I would remind you that the extent to which countries have been able to purchase goods has helped expand world trade and conferred significant benefits on other countries—not the least of which is the United States, where exports of goods now account for nearly 13 per cent of the gross national product, more than double what it was 20 years ago.

TABLE I

SIZE AND MATURITY STRUCTURE OF DEVELOPING COUNTRY EXTERNAL BANK DEBT

(includes OPEC)

Year (as of June)	Total $ bil.	Due Within One Year $ bil.	Due Within One Year As % of Total External Bank Debt %	U.S. Nonfinancial Corporations: Short-Term Liabilities as % of Total %
1978	155.3	71.9	46.3	42.8
1979	203.1	91.9	45.2	45.3
1980	247.1	114.2	46.2	46.1
1981	289.0	142.5	49.3	46.9
1982	343.5	171.8	50.0	49.3

Source: Bank for International Settlements; Federal Reserve

It may be true that an increased amount of borrowing at the country level is being used to service previously incurred debt and/or pay for imports for consumption, instead of being used to develop an infrastructure to generate an income stream. However, recent developments suggest that this deterioration has not been confined to countries alone, but rather, is symptomatic of the times we live in. In other words—rather than being the result of financial mismanagement either on the part of the lender or borrower, after four years of recession, high interest rates and declining commodity prices, it would be surprising if there *weren't* problems with country debt. Indeed, if the opposite were true, one could conclude that bankers had not been doing their jobs. There would be less in the way of sunrise industries and the OPEC surplus would not have been recycled so efficiently. At any rate, I would like to show the environment in which the debt situation made the

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headlines, and demonstrate that the worst appears to be over when it comes to these debt burdens.

Politics And Economics

First of all, the country debt situation should be divided into two major geographical areas: The Eastern Bloc and Latin America. After many years with no unusual developments, several Eastern Bloc countries were suddenly unable to service their debt, not only because of recessions in their major hard-currency export markets, but because of a change in political relations between the United States and Russia. As was observed in the September 1982 Economic Report, "some of the so-called problem loans confronting major banks today are the result of initiatives taken in Washington and elsewhere that in effect have made private banks and international markets the cutting edge of foreign policy." The Eastern Bloc encountered difficulties in part because of the different political climate imposed by the United States.

Nevertheless, the debt situation leaped to the front pages, for it had been unheard of for a country to declare that it simply did not have the money due its creditors. Not surprisingly, concern was heightened when several major Latin American countries made similar announcements—each for different reasons. In all of these cases, outstanding debt was rescheduled and new credit provided by a consortium of international banks and international lending agencies such as the International Monetary Fund. The September Economic Report discussed how the debt problem developed, beginning with quantum leap upward in oil prices late in 1973. What I would like to devote the balance of this Report to is a discussion of how this debt situation is improving.

All Maturities Have Shortened ...

One of the reasons why some countries find debt difficult to service is that it has increasingly become short term in nature. Table I shows that bank debt due within one year has risen as a per cent of total bank debt incurred by developing countries from 46 per cent at midyear 1978 to 50 per cent by midyear 1982. But this did not occur in a vacuum, as you can see from the trend of short-term debt for U.S. nonfinancial corporations during this time; it rose almost twice as fast! And as the U.S. government's debt managers will attest, increasing reliance on short-term debt leads to an increasing need to roll it over. In the case of country debt, this has turned manageable liquidity problems into a global financial challenge.

Plainly, if governments could transform their short-term debt into medium- and long-term obligations, their present difficulties would substantially ease. It would also make them less subject to the uncertainties of

TABLE II

NON-OPEC DEVELOPING COUNTRIES' DEBT BURDEN

Year	Medium- & Long-Term External Debt As % GDP	Medium- & Long-Term External Debt As % Goods & Services Exports	Principal & Interest Payments As % Goods & Services Exports	U.S. Nonfinancial Corporations: Interest Payments As % Cash Flow
1973	16.6	88.7	14.0	28.1
1974	16.3	80.6	11.5	36.8
1975	18.3	97.7	14.0	25.2
1976	20.5	102.6	13.9	21.0
1977	22.1	104.9	14.0	19.7
1978	23.7	111.2	17.3	20.7
1979	22.7	101.9	18.1	23.5
1980	21.8	92.9	16.3	25.9
1981	24.3	103.2	21.0	26.2
1982(e)	25.2	109.1	22.3	30.3

Source: International Bank for Reconstruction and Development; Commerce Dept.; MHT estimates

interest rates; the combination of shorter and shorter debt maturities with ever-rising interest rates was largely responsible for today's debt concerns. As you can see from Table II, while medium- and long-term external debt of the non-OPEC developing countries has held fairly steady relative to the size their economies and to their exports over the past few years, their interest and principal repayments as a per cent of exports have increased markedly. However, so did interest payments as a per cent of cash flow of U.S. nonfinancial corporations.

... But Debt Burdens Are Diminishing ...

Nevertheless, the ability to handle this debt seems to be improving. For one thing, interest rates have come down dramatically in the past few months. Each percentage point decline in the London Interbank Offered Rate (LIBOR) reduces the annual interest payments of Brazil and Mexico together by at least $1 billion. Consequently, the seven percentage point drop in LIBOR since mid-1982 has already shaved interest payments of these two countries alone by $7 billion annually—equivalent to over ten per cent of all LDC interest payments in 1982 (estimated at $65 billion). Aside from this, it would appear that the non-OPEC developing countries' current account balance has begun to improve as a result of continued growth in merchandise exports and a curtailment of imports.

As Table III indicates, in 1982 there was a reduction in these countries' aggregate deficit to below 1980 levels. And with merchandise exports estimated to have grown

some 7½ per cent during this time, the ratio of the current account deficit to merchandise exports has dropped from a recent high of 27 per cent to 21 per cent. This is the lowest since 1979 and is far below the peaks reached in 1974 and 1975. External debt outstanding of the non-OPEC developing countries was not much higher in 1982 than in 1978 when compared with exports. And, as you can see, interest payments as a per cent of exports and reserves has begun to fall as well.

... With Further Progress Likely

Besides these improvements already underway, there are other developments pending which will further alleviate this debt situation. For one thing a resumption of growth in the United States as well as in the countries of the industrialized West will go a long way toward helping the less developed countries manage their debt. If LDC exports grow no more this year than they have on average during the first year of recovery from the three previous cycles then the dollar value of their exports will rise by over $30 billion—equivalent to nearly half of their total interest payments in 1982!

Increased demand for exports will undoubtedly firm up commodities prices. Prices of the goods that developing countries export must return to their proper position relative to other prices especially oil, if these countries are ever to reduce their debts to more manageable proportions. For the international payments system never had a situation where the same countries would run consistent and growing payments deficits year after year as it has since OPEC first boosted oil prices in 1973.

TABLE III

EXTERNAL POSITION OF THE NON-OPEC DEVELOPING COUNTRIES

Year	Non-OPEC Developing Countries Current Account Balance	Non-OPEC Developing Countries Merchandise Exports	Current Account Balance As % Merchandise Exports	Interest Payments As % of Exports Plus Reserves
	$ bil.	$ bil.	%	%
1973	-12	86.4	13.9	5.7
1974	-37	123.0	30.1	5.5
1975	-47	120.7	38.9	7.4
1976	-33	140.3	23.5	6.8
1977	-29	164.8	17.6	7.0
1978	-31	188.3	16.5	8.2
1979	-48	244.6	19.6	9.5
1980	-75	311.9	24.0	10.9
1981	-86	324.2	26.5	15.6
1982(e)	-70	335.0	20.9	15.4

Source: International Monetary Fund; International Bank for Reconstruction and Development; MHT estimates

Having said this, it must be recognized that there remains an enormous overhang of debt, particularly short-term bank debt, which could affect the non-OPEC developing countries for many years, even in a period of economic growth. Thus, one must come to the conclusion that countries, like corporations, need a mechanism to reduce their dependence on fluctuations in the cost and availability of short-term credit. Right now, many companies in the private sector have begun funding a sizable portion of their short-term debt in the bond markets thereby improving their balance sheets. Some developing countries, however, have no such option other than to reschedule. If only modest amounts of short-term debt could be transformed into medium- and longer-term obligations, the present difficulties of several developing countries would be significantly alleviated, diminishing the constant rollover problem and improving key liquidity ratios back to more manageable levels, such as those of the mid-1970s.

Although no such mechanism now exists, this is an area in which official institutions should assume an active role. Indeed, they should consider providing not only long-term debt, but equity capital as well. This would help to reduce strains in the debt markets while at the same time gearing the return on this equity investment to the ability of the borrowing countries to pay—especially if dividends were to be tied to the price of these countries' export commodities.

Conclusions

Let me sum it up. First of all, debt is an integral and a necessary part of economic growth and improved living standards. Second, it is the function of banks and other financial intermediaries to get savers and borrowers together in order to meet their respective needs. Admittedly, the debt situation for some countries had become burdensome. However, this was exacerbated by the withdrawal of liquidity by some marginal lenders, and not because of a worsened internal economic climate. Indeed, such recent developments as a reduction in imports and consequent improvement in trade accounts, along with lower interest rates and a revival of economic growth are signs that many countries have turned the economic corner. This process will reduce debt burdens, but it would be enhanced if a facility were made available to governments that would permit them to exchange short-term debt for long-term debt (or equity) as private sector companies do.

As necessity has many times tended to be the mother of invention, I am hopeful, if not confident, that such a facility will soon develop. Until then, just think about what kind of world this would be if everybody listened to Polonius.

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